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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

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UNION PACIFIC'S REPLY COMMENTS

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REPLY COMMENTS

Union Pacific Railroad Company and Union Pacific Corporation (collectively, "UP") submit these comments in response to proposals and positions in the May 16 initial filings. Obviously, UP does not attempt to address every issue raised in the parties' initial comments, but rather only those items that raise issues of special interest or concern. We begin by discussing the scope of the Board's rules. We then review each of the major topics on which the Board requested comments. We close by reviewing several miscellaneous topics added by commenting parties.

I. Applicability of New Merger Rules

A. New Rules Should Apply Only to Future Class I Mergers

Some parties propose sweeping changes to rail regulation that lie well beyond the scope of rail merger proceedings. For example, some have asked the Board to rescind its Midtec decision and require all Class I railroads, whether or not they participate in a major merger, to submit to mandatory switching or other forms of access for their exclusively-served shippers. See, e.g., Certain Coal Shippers Comments, pp. 14-15; Oklahoma Gas & Electric Comments, p. 7. Others seek across-the-board reversal of the Board's Bottleneck rate decisions. See, e.g., NITL Comments, pp. 16-18; TFI Comments, pp. 5-6.

The Board has already held that general overhaul of the existing regulatory framework lies beyond the scope of this rulemaking and would undermine the Board's policy and regulatory objectives. The genesis of this proceeding was the Board's desire to receive public comments on the implications of further railroad consolidations. In response to those comments, it initiated this rulemaking to "provide new merger rules," not to re-regulate the industry generally. The Board expressly rejected calls by certain parties to "revisit the issues that we studied in-depth 2 years ago in our proceeding in Review of Rail Access and Competition Issues, STB Ex Parte No. 575" by "chang[ing] the rules in a variety of ways so as to promote more rail-to-rail competition throughout the industry." STB Ex Parte No. 582 (Sub-No. 1), Decision served Mar. 17, 2000 ("March 17 Decision"), p. 6.

The Board noted that such a "complete overhaul of the existing regulatory scheme . . . could introduce an additional level of uncertainty and risk into the industry, thereby harming shippers by lowering aggregate rail investment below those levels necessary for railroads to maintain and improve service." Id. This would worsen, rather than alleviate, the "key problem faced by railroads" and their shippers: "how to improve profitability through enhancing the service provided to their customers," which is "linked to adding to insufficient infrastructure, not to eliminating excess capacity." Ex Parte No. 582 (Sub-No. 1), Advanced Notice of Proposed Rulemaking, served Mar. 31, 2000, p. 3 ("ANPR") (quoting March 17 Decision, p. 6).

The Board cannot consider in this proceeding broad changes to railroad regulation, particularly those that would have devastating effects on the ability of railroads to invest in essential infrastructure.[1] The Board cannot fairly or rationally impose such changes in this proceeding after telling the parties it would *not* consider such changes. The Board should not contemplate changes that we believe could cripple the rail industry without giving railroads and other affected parties full notice and an opportunity to be heard on a complete record.

The Board recently and correctly declined to make sweeping changes to rail regulation on the basis of fully developed records. Just two years ago, the Board conducted a probing evaluation of competitive access proposals in Ex Parte No. 575, concluding that new access measures "risk completely undoing the progress made towards a healthy railroad system capable of meeting customers' needs." Ex Parte No. 575, Review of Rail Access and Competition Issues, Decision served Apr. 17, 1998, p. 4. In the Bottleneck proceeding, the Board conducted a similarly thorough evaluation of its regime of rate regulation, concluding that a general obligation to quote separate rates for every "bottleneck" segment would conflict with the "statutory provisions allowing carriers to select their routes and to protect their long-hauls." Docket No. 41242, Central Power & Light Co. v. Southern Pacific Transportation Co., Decision served Dec. 31, 1996, ("Bottleneck I") p. 11. Nothing has changed in the last few years that would

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1 As Professor Jerry Hausman and several others testified in Ex Parte No. 582, the mere pendency of a Board proceeding to consider sweeping new regulatory burdens on railroads would create significant uncertainty in financial markets that could deprive railroads of the investment capital they require. Ex Parte No. 582, Public Views On Major Rail Consolidations, Statement of Jerry A. Hausman, Feb. 29, 2000, p. 11. We incorporate Professor Hausman's testimony by reference.

support revisiting the Board's prior conclusions. If anything, the economic condition of the railroads is less secure than during those earlier proceedings.[2]

Economists, investment bankers, stock analysts, and railroad managers all testified in the earlier proceedings about the adverse consequences of regulatory proposals that would require carriers to give access to their infrastructure or to establish separately-challengeable "bottleneck" rates. Many shippers and shipper organizations joined these industry experts in warning about the effects of new regulation.[3] That testimony is equally applicable to the proposals for non-merger regulatory changes in this proceeding. Accordingly, UP joins NS and CSX in placing the salient portions of the evidence from those proceedings into this record as well.[4]

Those proposing to restructure railroad regulation do so in the name of competition. But this new "competition" relies on the creation of regulatory mechanisms that would deny market-based returns to railroads. As explained by Professor William J. Baumol, who played a pivotal role in helping the ICC develop the post-Staggers Act

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[2] The industry has not become more concentrated than it was during those proceedings. The BN/Santa Fe and UP/SP mergers had been completed, and the Conrail proceeding was well underway.

[3] For example, the following shippers among many others opposed expansion of the "bottleneck" rate regulation: American Honda Motor Co.; APL Limited; Amvest Coal Sales, Inc. Bay Area Piggyback, Inc.; Canerbury Coal Company; Coors Brewing Company; FMC Corporation; "K" Line America, Inc.; L.B. Foster Company; Mark VII Transportation Company, Inc.; New York State Electric & Gas Corporation; Port of Baltimore; Port of Houston Authority; Port of Oakland; Port of Portland; Port of Seattle; Price/Costco; Rover Hill Coal Company and Tahoma Coal Sales, Inc. See Comments of the Association of American Railroads filed October 15, 1996 in Docket No. 41242, Central Power & Light Co. v. Southern Pac. Transp. Co.

regulatory framework, these new regulations would be economically disastrous for the railroads. Terminal access and "bottleneck" rate proposals would result in artificial competition based on artificially low compensation for use of rail facilities, interfering with the efficient provision of rail service. See Verified Statement of William J. Baumol, entitled "Mandatory 'Competitive Access' Proposals: Camouflaged Attempts to Impose Uncompensatory Rate Reregulation."[5]

Because these principles are so well established, we merely summarize some of the most serious problems with forced access and "bottleneck" rate proposals:

- These proposals would sharply reduce railroad revenues that support re-investment in the network. They would undermine the railroads' ability to engage in demand-based or differential pricing, without which railroads would be unable to cover their large fixed costs. Investors would be unwilling to provide railroads with the capital needed for infrastructure investment, and disinvestment in the industry inevitably would result. The big losers from a downsizing in the network would be small shippers and those who pay the lowest rates.[6]

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4 See "Joint Compendium of Prior Railroad Submissions on Forced Access and Bottleneck Rate Issues," filed today in this proceeding.

5 Professor Baumol's statement, jointly commissioned by CSX, NS and UP, is attached as Exhibit 1.

6 CMA witness McCormick suggests that a regime of forced access would not necessarily eliminate differential pricing and that the competing carriers would find a "market equilibrium" with rates that are "just sufficient to cover total costs." CMA Comments, McCormick V.S., p. 27. In an industry that is already persistently revenue inadequate, this is a dangerous conclusion. But, even if it were correct, it would mean that many shippers who now benefit from modal competition would suffer significant rate increases so that rates for previously "captive" customers could be reduced. Because of competition, that limits rates for shippers with modal competition, these increases would drive traffic off the railroads. The new "equilibrium" would be on a shrinking rail system.

- Non-incumbent carriers would "cherry pick" the most profitable traffic on particular lines, leaving the incumbent carrier that owns the line with the obligation to maintain its infrastructure but with less traffic, lower-margin customers, and lower net revenues.

- New traffic would not magically appear to make up for the revenue and earnings losses that would result from these new regulatory policies. If railroads could increase their profits by lowering their rates, they would do so today.

- Some parties argue that measures imposing access in other regulated industries demonstrate the feasibility and wisdom of imposing similar measures on railroads. As Professor Baumol explains, however, the circumstances in those other industries render their experiences inapplicable to the railroad industry. In the other industries, for example, access was imposed to overcome the limitations of a regime of rate regulation that -- unlike railroad rate regulation -- did not apply on an "end-to-end" basis to all aspects of the complementary services (e.g., local and long distance telephony). These rate regimes allowed self-favoring discriminatory behavior by incumbent owners of a bottleneck. In the other industries, access was imposed to promote entry at a time when new technologies and low cost providers (not present in modern railroading) were becoming increasingly available, but would be discouraged or prevented by owners of monopoly facilities. And in those other industries, access did not have the adverse consequences -- for operational coordination and revenue adequacy -- that would occur in the rail industry. Baumol V.S., pp. 12-13.

- Open terminal access would create a new set of disputes concerning the appropriate measure of compensation. The Board could not constitutionally rely on the level of existing, agreed-upon reciprocal switch charges to establish a reasonable level of compensation. Class I carriers are willing to agree to charge each other reduced fees for the switch services they provide one another because the low fees are reciprocal. Fees for forced access that fail to make the carrier whole for its losses – including the lost profits on traffic secured by competitors via forced access – would result in an unconstitutional taking.

- Forcing open all possible interchanges would lead to serious operating inefficiencies. Traffic flows would be

> fragmented, preventing economies of density from being achieved. Carriers could not structure their networks as efficiently, resulting in degraded service and hampering the development of new approaches to marketing rail service via the Internet.

B. New Rules Should Apply Only to Merger Applicants

UP opposes proposals that would apply new regulations to carriers other than the applicants seeking a merger. For example, some parties suggest a rule not only requiring applicants to make competitive access arrangements for their exclusively-served shippers but also imposing a reciprocal obligation on any other carrier serving the same terminals to open their exclusively-served shippers to access. See, e.g., Washington Ports Comments, p. 10 n.6. Other parties suggest that it would be unfair to saddle merger applicants with competitive access or "bottleneck" regulation while their competitors, not pursuing a merger, avoid such regulations. See, e.g., BNSF Comments, pp. 25-26; CN Comments, pp. 30-31.

UP believes that any new rules must apply only to merger applicants.[7] The Board's authority to condition a proposed merger in the public interest is broad in part because merger approval is permissive rather than mandatory. Participants in a merger are permitted to choose whether to proceed with their proposed transaction as conditioned by the Board. If conditions protecting the public interest are too onerous,

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[7] UP supports one and only one exception to this principle, as discussed in our initial comments. If a carrier extends its system as a result of a grant of trackage rights imposed as a condition on a merger or as part of a merger settlement, and thereby creates a new "bottleneck" or extends an existing "bottleneck," the merger rules governing "bottleneck" rates ought to apply. In that instance, the extended "bottleneck" is a direct effect of the transaction in which the benefiting carrier participates. See UP Comments, pp. 11-14.

the applicants may abandon their transaction.[8] If the Board imposes substantive requirements on non-applicants, however, those carriers would have no ability to veto the merger and avoid the obligations. It is the merger applicants who seek economic gains from the merger, often at the expense of other railroads, and they should bear the costs of protecting public concerns.

Imposing obligations on non-applicants raises significant statutory and constitutional concerns as well. Section 11324(e) does not authorize such conditions. Under the takings clause of the U.S. Constitution, government bodies may not impose economically harmful conditions on third-parties who are not themselves applying for public benefits. See generally Dolan v. City of Tigard, 512 U.S. 374 (1992); Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987).

Nor would it be appropriate to impose conditions on a non-applicant merely because that carrier benefits from conditions imposed by the Board or agreed to in a merger settlement to resolve a competitive harm of the merger unless the condition itself creates the harm. Imposing new burdens on such carriers could effectively extinguish the Board's power to remedy merger-related harms, because non-applicant carriers would be less likely to seek or implement conditions. The losers would be the shippers whom conditions protect.

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[8] See, e.g., Guilford Transp. Indus., Inc. – Control – Boston & Maine Corp., 5 I.C.C.2d 202, 206 (1989); Chicago & Northwestern Transp. Co. -- Construction & Operation of a Line of Railroad, 363 I.C.C. 906, 955 (1981) ("parties can choose not to consummate a transaction because of the burden of conditions we impose").

Some parties suggest that any competitive access rules must be applied more broadly than to just the merging carriers, lest shippers on other railroads be placed at a competitive disadvantage. See, e.g., Certain Coal Shippers Comments, p. 8; DOT Comments, pp. 13-14; NITL Comments, p. 12. Yet differences among shippers with respect to their transportation options are nothing new, and the Board has consistently rejected attempts to equalize the competitive situations of individual shippers.[9] It should do so here.

C. New Merger Rules Cannot Apply Retroactively to Prior Mergers

Several parties recommend that, as part of the Board's analysis of future Class I merger proposals, the Board reconsider conditions that it imposed in prior merger decisions involving the same carriers or their predecessors. See, e.g., DOT Comments, pp. 36-37; Greater Houston Partnership Comments, pp. 6-7; Iowa Traction R.R. Comments, pp. 3-4; and KCS Comments, pp. 21-32.

No new rule is needed to allow the Board to protect prior merger conditions in a subsequent merger proceeding. When the Board conditions Merger 1 by granting trackage rights to Carrier A, and then the parties to Merger 1 propose to acquire

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[9] See, e.g., CSX/NS/Conrail, Decision No. 89 served July 23, 1998, pp. 70-71 ("The ICC and the Board have consistently declined to attempt to equalize the rail transportation options of shippers who receive merger benefits and all those who do not."), 113 (rejecting request of ASHTA Chemicals to "prevent it from being placed at a competitive disadvantage vis-à-vis other shippers that will receive better or more competitive service as a result of the merger), 115 (rejecting similar request of Eighty-Four Mining based on "usual rule that we will not equalize merger benefits among competing shippers"); BN/Santa Fe, Decision No. 38, served Aug. 23, 1995, p. 99 ("condition requiring that a [merger-related] settlement agreement be changed to improve a particular shippers competitive situation is not proper" where shipper complains that (continued...)

Carrier A in Merger 2, it is axiomatic that the Board must consider the impact of Merger 2 on the condition imposed in Merger 1. The ICC confronted this situation in the UP/MKT merger, where the Board found it necessary to transfer to KCS the rights that had been granted to MKT in the UP/MP merger. UP/MKT, 4 I.C.C.2d 409, 452-58 (1988).

Some parties, such as KCS, would go further. They urge the Board to conduct a sweeping reassessment of all prior merger conditions, not just those potentially affected by the subsequent transaction, to determine whether they remain "consistent with evolving notions of the public interest."[10]

The Board lacks authority under 49 U.S.C. § 11324(c) to reach back to a prior merger and "re-condition" it based on a new set of substantive standards. But such oversight does not extend to "relitigat[ing]" the Board's underlying public interest determination reflected in its original decision approving the merger.[11] Doing so would contravene the fundamental right the applicants in the prior merger proceeding to choose whether to accept the Board's conditions as the price of going forward with the

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settlement agreement provided increased rail options for shipper's competitors to the shipper's competitive disadvantage).

[10] KCS proposes that future merger applicants be required to include in their application "(1) a full disclosure of all conditions granted to third parties in prior mergers in which they or their predecessors were involved, (2) an analysis of the continued validity of, or necessity for, any restrictions (operating, access, traffic, etc.) contained in prior conditions, and (3) an assessment of whether or not those conditions could be modified in such a way as to actually promote and enhance competition, and whether the restrictions remain consistent with evolving notions of the public interest." KCS Comments, p. 22.

[11] UP/SP General Oversight, Decision No. 10 served Oct. 24, 1997, p. 14.

transaction.[12] To be sure, the Board has authority to impose oversight requirements that allow it to "consider whether [conditions] have achieved their purpose" of ameliorating merger-related harms and to modify conditions to achieve that purpose.[13] Finally, such a rule would upset the finality of the Board's prior determination that the first merger was in the public interest.

KCS's version of the proposal appears to be self-serving. It is designed to force reconsideration for the third or fourth time of the Board's limitation on trackage rights granted to KCS affiliate Tex Mex in the UP/SP merger. KCS Comments, pp. 30-32.[14] Of course, KCS would be free in any future merger case to argue for expansion of

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[12] See, e.g., Guilford Transportation Industries, Inc. – Control – Boston & Maine Corp., 5 I.C.C.2d 202, 206 (1988) (discussing problems posed by post-consummation request for new trackage rights conditions made Court of Appeals remand for further proceedings and rejecting proposed conditions without reaching timeliness question); Landgraf v. USI Film Products, 511 U.S. 244, 280 (1994) (holding that rule is impermissibly retroactive if it "increase[s] a party's liability for past conduct, or impose[s] new duties with respect to transactions already completed").

[13] UP/SP General Oversight, Decision No. 13 served Dec. 21, 1998, p. 16; see also CN/IC, Decision No. 37 served May 25, 1999, p. 37-38 (establishing 5-year oversight to evaluate "effectiveness of the various conditions we have imposed" and retaining jurisdiction to "impose additional conditions if, and to the extent, we determine that additional conditions are necessary to address unforeseen harms caused by the transaction").

[14] When the Board granted Tex Mex trackage rights between Robstown/Corpus Christi and Beaumont, it limited Tex Mex's rights to traffic having a prior or subsequent movement on Tex Mex's original Robstown/Corpus Christi-Laredo line. KCS has long wanted Tex Mex to use its rights to provide KCS with access to traffic originating and terminating in Houston, but the Board has consistently rejected that position, holding that unrestricted "Houston-north" rights are not justified by any adverse impact of the merger on competition or essential services. UP/SP, Decision No. 44 served Aug. 12, 1996, pp. 85-89; UP/SP, Decision No. 62 served Nov. 27, 1996, pp. 6-9 (rejecting KCS/Tex Mex Petition to Reopen); UP/SP Houston/Gulf Coast Oversight, Decision No. 10 served Dec. 21, 1998, pp. 10, 16-18.

Tex Mex's rights, but only if a future merger should have adverse competitive consequences that such an expansion would remedy.

D. New Merger Rules Should Apply to All Class I Carriers

The Board's merger rules should apply equally to all future mergers among Class I railroads. The Board should not exempt certain Class I railroads from the Board's rules. There is no basis for concluding *ex ante* that a merger proposal involving any two of the remaining Class I railroads would avoid the fundamental concerns that gave rise to this proceeding – i.e., the need for rules that are "adequate for addressing the broad concerns associated with reviewing any proposals that, if approved, would likely lead to just two large North American transcontinental railroads." ANPR, p. 2. To the contrary, any such transaction would likely precipitate a series of strategic responses that would swiftly lead to further consolidation among the remaining Class I railroads.[15]

Nor should any merger between Class I railroads be treated as "significant" rather than "major," as KCS proposes. KCS Comments, pp. 64-81; see also Wisconsin Central Comments, pp. 5-6. Such treatment would encourage mergers by declaring the Board's moratorium order inapplicable to such transactions and expediting their review. It also would significantly constrain the Board's ability to review the merits of such a proposal by supplanting the broad public interest standard applicable to major mergers with an affirmative obligation to approve the application unless the Board

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[15] If in an appropriate case the applicants are able to make a persuasive showing that, because of the nature of their transaction, specific requirements of the Board's major merger rules properly should not apply to their proposal, they would be free under the Board's existing rules to request an advance waiver of those requirements. See 49 C.F.R. § 1180.4(f).

concludes, under 49 U.S.C. § 11324(d), that the merger would result in a "substantial lessening of competition" and also that "the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs."

II. Downstream Effects

Commenting parties offer strong support for the Board's suspension of its "one-merger-at-a-time" rule and its proposal to consider "downstream" effects in merger proceedings. Of the approximately 120 comments filed, fewer than a handful ask the Board to ignore downstream effects. Two of those are BNSF and CN, which propose to merge. BNSF Comments, p. 4; CN Comments, pp. 17-18.

BNSF proposes a concept of "downstream effects" so crabbed as to be meaningless. BNSF Comments pp. 13-14. BNSF suggests that merger applicants disclose only one "downstream" effect: whether they expect to disrupt services on other rail carriers. Id. As no rational merger applicant would predict that its merger would cause service failures on any carrier, this proposal is a meaningless gesture. Every railroad in this proceeding proposes new implementation planning to make it impossible for applicants to predict such a calamity.

BNSF and CN insist that the Board need not consider the possibility that the railroad industry will consolidate to two major carriers, because their proposed transaction would not necessarily cause that result. If railroads move toward the final consolidation of North American railroads, they say, it will be someone else's fault in some other merger, a merger the Board can block. Their position overlooks the role of their proposed merger in launching a final consolidation of North American railroads.

The proposed BNSF/CN consolidation is not only likely to trigger responsive mergers by others, as the Board has recognized, but is itself a giant step toward a two-carrier Class I rail system in North America. The BNSF/CN proposal would create the largest railroad in North America with the first single-carrier transcontinental routes between the West Coast of the United States and an Atlantic Ocean port. The BNSF/CN proposal has already revitalized the drive for rail re-regulation that BNSF's CEO Rob Krebs has said would be "an absolute disaster" for the rail industry.[16] The impact of a merger proposal on rail regulation is another major "downstream" effect.

BNSF and CN argue that attempting to predict specific future transactions requires too much speculation. E.g., BNSF Comments, p. 14. UP proposed a rule that would only require applicants to evaluate whether a two-railroad Class I network is in the public interest, sparing applicants the need to predict specific transactions. They would be required to take responsibility for their permanent transformation of the North American rail system by evaluating the desirability of a more concentrated industry under each public interest consideration. In particular, they must address the impact of greater industry concentration on the risk of re-regulation, a risk that BNSF has recognized would be so devastating for the U.S. rail industry.

BNSF and UP propose similar rules for procedural consolidation of contemporaneous applications (BNSF Comments, p. 15; UP Comments, p. 5), but BNSF adds a restriction that renders the consolidation procedure meaningless. BNSF insists that, even in a combined proceeding, the applicants who file first should never shoulder

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16 Christopher Palmori, "Spending Their Way Out of Trouble," Forbes, Mar. 23, 1998 p. 72.

conditions to correct the adverse effects that the second proposal may have on the public interest. BNSF Comments at 15. BNSF wants to shift all responsibility for curing problems to the second set of applicants. This not only would create a race to the Board, but eviscerate the purpose of combining the applications. To produce outcomes that are both rational and fair, the Board must be able to impose conditions to remedy the interactions between contemporaneous mergers on any applicant.

III. Safety

CPUC proposes that merger applicants should be required to submit an "enhanced" Safety Integration Plan and that the guidelines for such safety plans that are currently under consideration in the joint Board/FRA rulemaking should be expanded to include additional elements. CPUC also maintains that any railroad with an accident rate that is higher than the industry average should not be permitted to merge until its safety record improves.

CPUC's comments with respect to the Safety Implementation Plan are beyond the scope of the ANPR. The Board noted in the ANPR that safety concerns are encompassed by its environmental rules at 49 C.F.R. Part 1105, which are not specific to rail mergers, and it expressly stated that it does not intend to alter those rules in this proceeding. ANPR, Note 15. The ANPR makes specific reference to the separate joint rulemaking that was instituted by the Board and FRA for the purpose of considering the very issues that CPUC has raised here. ANPR, Note 16. Many of the "enhancements" to the safety plan that CPUC has proposed, including review of training, engineer certification, emergency response plans, and the dispatching and train control systems to be adopted are already under consideration in that docket. See Regulations on Safety Integration Plans Governing Railroad Consolidations, Mergers, Acquisitions of Control, and Start Up Operations, and Procedures for Surface Transportation Board Consideration of Safety Integration Plans in Cases Involving Railroad Consolidations, Mergers, and Acquisitions of Control, Ex Parte No. 574, FRA Docket No. SIP-1, Notice No. 1 (Joint Notice of Proposed Rulemaking published at 63 Fed. Reg. 72225 (Dec. 31, 1998)).[17]

CPUC would require the merging railroad to submit its proposed operating rule changes governing allowable train configurations to FRA for approval prior to their taking effect. The carriers would also be required to provide FRA with its technical justification for the changes, including a track-train dynamics analysis. However, FRA has previously considered whether to adopt national requirements for train make-up and concluded that this matter is best left to individual carriers, because compliance with prescribed train make-up rules could require additional switching operations which pose a potentially greater risk of derailment than operating poorly configured trains.[18] FRA also rejected a proposed rule that would require advance approval of changes in a railroad's rules because FRA agreed that such a rule would "seriously impair rail management's flexibility to amend [its] programs in light of changing operating conditions." 39 Fed. Reg. 41,175-6 (1974).

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[17] CPUC alternatively suggests that the safety "enhancements it seeks should be adopted on an interim basis." However, in the ANPR, the Board has already announced its intention to have applicants continue to work with FRA to formulate Safety Integration Plans on a case-by-case basis.

[18] Letter from FRA to NTSB dated July 14, 1982 in response to NTSB recommendation R-78-0446 that FRA "limit the length and tonnage of trains" in accordance with "train make-up principles developed under the track train dynamics program." In an order dated October 1, 1982, the NTSB adopted FRA's suggestion and closed its consideration of new regulations based upon its finding that acceptable action had been taken by FRA.

Rail mergers have not been shown to increase risk of derailments attributable to train make up or track-train dynamics ("TTD-TMU"). CPUC closely monitors the rate of incidents at selected heavy-grade sites in mountainous areas of California, but neither BNSF nor UP/SP experienced any increase in TTD-related derailments at these locations following their recent mergers. Analysis of the accident data reveals that TTD-related derailments were significantly lower in the decade from 1987-1997, after most of the mergers occurred, than during the previous decade from 1976-1986. (See TABLE from Case No. C-9703660-THE). In fact, the rate of accidents attributable to all causes at the monitored sites declined significantly after 1986, which is consistent with the downward trend in accidents for railroads nationwide.

It would be imprudent to deny a railroad whose safety record falls below the industry average the opportunity to merge with a stronger partner. Mergers can improve safety in certain circumstances. UP's acquisition of the former Western Pacific ("WP") in 1983 was a significant factor in the decline in derailments in California. By 1986, UP had completely rebuilt the former WP line through the Feather River Canyon, into a key link in one of UP's transcontinental routes through the Central Corridor. Before it was rebuilt, the Feather River line had the highest accident rate of all the CPUC-monitored mountain grade sites, with a total of 15 derailments during 1976-86. Only one accident due to track was recorded at this site from 1987 to 1997. WP lacked the financial resources to make these safety-enhancing improvements on its own, and its merger with UP was clearly necessary to promote the safety of this important component of the national transportation system. In addition, accident rates differ because of differences in operating patterns (such as the amount of yard switching), even on equally safe railroads.

IV. <u>Service Issues</u>

A. <u>Avoiding Service Failures</u>

Most railroads and many other parties proposed more extensive implementation planning than current merger rules require. Improved implementation planning should help avoid service failures.

The Eastern Coal Traffic Association ("ECTA") proposes that implementation plans should include shipper support functions. ECTA Comments, pp. 9-10. UP concurs. As testimony in Ex Parte 582 showed, many shippers feel that customer service and railroad responsiveness to shippers have declined after recent rail consolidations.[19]

Although many of the service proposals have merit, UP has concerns about a few. For example, Amtrak proposes that the merging railroads should be required to perform capacity studies wherever a merger would add four trains a day. Amtrak Comments, p. 6 n.2. UP believes this approach is too rigid and could require applicants to waste resources on studying line segments and terminals that do not present capacity concerns. The numerous proposed rules requiring railroads to show they possess capacity adequate to avoid service failures should satisfy Amtrak's concerns.

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[19] Testimony of Tricia Bennett, Shearer Lumber-Bennett Lumber, Ex Parte No. 582, Mar. 9, 2000; Testimony of Hal Owens, Precision Components, Ex Parte No. 582, March 9, 2000, Testimony of Rail Van Global Logistics, Ex Parte No. 582, Mar. 8, 2000; Testimony of Paul Freund, MidAmerican Energy, Ex Parte No. 582, Mar. 8, 2000.

UP also disagrees with Amtrak's proposal that non-applicants proposing conditions to remedy merger-related harms must carry the burden of showing that their proposed conditions would not cause capacity problems. Amtrak Comments, pp. 5-6. This would unnecessarily burden parties who are trying to solve a problem caused by the applicants and could make it impossible to condition mergers properly. In addition, the conditions will apply to the applicants' lines, which means the applicants will be better able to evaluate line and terminal capacity. The better solution is to require merger applicants to work with a party obtaining a condition to ensure adequate capacity.

UP disagrees with the Ohio Rail Development Commission's ("ORDC") proposal that railroads be prohibited from merging until all benefits of prior mergers are achieved. ORDC, pp. 1, 10. Such a rule could hobble a railroad's ability to use a responsive merger to remain competitive. It would also lead to potentially endless disputes about the extent to which benefits have been achieved in a rapidly changing commercial environment.

Finally, UP is concerned about proposals to use panels of experts to judge implementation plans and merger implementation. See, e.g., Transition Comments at 4, 7-9; Port of Seattle Comments at 18. The Board may benefit by supplementing its staff to evaluate plans and identify potential issues, a practice UP supports. However, the Board should not create a costly new bureaucracy that could never be as familiar with local and systemwide operating circumstances as the owning railroads. At all costs, the Board should avoid turning merger implementation into an ongoing legal proceeding that will cripple railroad flexibility and absorb the time and energies of the very operating officials who need to fix any problems that arise. We also are concerned about delegating to "experts" Board authority to direct railroads to operate in certain ways or to evaluate service quality. The Board should retain its authority.

B. Evaluating Service Problems

UP provided by far the most detailed proposal for measuring service failures. We concluded that shippers, the applicants, and the Board could avoid protracted service-related disputes only by using a consistent set of detailed base-line data. Other parties have suggested that merger applicants develop case-by-case approaches to remedying service problems, which the Board would consider in evaluating the public interest. UP would have no objection to such proposals, if the Board determines that detailed measurements are not necessary.

UP disagrees with several service evaluation proposals offered by other parties. First, the Salt River Project's presumption that all service declines are merger-related is unwarranted. Salt River Comments, p. 7. Many are not. For example, major non-merger track maintenance may cause delays, as could floods and other weather problems unrelated to a merger. See Finance Docket No. 33726, Western Coal Traffic League v. Union Pacific R.R., Decision served May 12, 2000, p. 5. Second, some parties proposed using shipper surveys as a means of evaluating service. Transition Corp. Comments. Shipper surveys can be beneficial to railroads, but they frequently are impressionistic and often are based on outdated information that is not suitable for imposing remedies. Surveys usually do not diagnose the causes of service problems, nor do they identify remedies to solve problems. Third, the CPUC's proposed performance standards are unnecessarily detailed. Many, such as reviewing accident reports, reviewing locomotive engineer training and certification, and examining car utilization rates (CPUC Comments, pp. 4, 6), do not measure service in any meaningful way and would do little more than add regulatory burdens.

Finally, several parties propose that the Board establish an arbitration or mediation process for shipper complaints in the event of significant service deterioration. UP supports mediation processes and believes that fair and expeditious resolution of shipper complaints is an important part of the railroads' responsibilities in implementing a merger. UP supports a mediation process that includes direct negotiation between business representatives of the railroad and shipper as the initial step in the process.

UP faced thousands of complaints and hundreds of claims for damages as a result of the service congestion in 1997 and 1998. UP implemented a process that resulted in paying compensation to its customers well beyond UP's likely legal liability. The initial step in the process was direct, informal negotiations between business representatives. Thanks to this process, less than two percent of all claims resulted in litigation. This is remarkable given the size, number, and complexity of the customer claims. UP also agreed with customers to use third party auditors when neces ry to verify claims. UP supports direct, informal negotiations among business representatives of each party, with formal mediation only in the event the parties failed to resolve the complaint.

C. Remedies for Service Failures

1. Compensation for Service Failures

UP believes that compensation should be limited only to increased transportation costs. UP opposes compensation for all possible claimed costs, such as consequential damages of claimed business losses. Such claims cannot easily be proved, and shippers would have no incentive to mitigate or control their costs if all are recoverable. Railroads could be exposed to a level of liability far in excess of that contemplated by ordinary contract law.

UP agrees that shippers should be compensated for merger-related costs of leasing additional private cars, as long as the lease costs are reasonably related to the duration of the problem. UP does not agree, however, that railroads should be required to pay long-term car leases as compensation for service problems. Long-term leases are capital investments, not temporary solutions.

UP also believes there is no need for the CPUC's proposed escrow fund to cover service failures. CPUC Comments, p. 6. Class I railroads are financially able to cover reasonable service-related costs, as UP demonstrated during its recent service crisis. In order to establish an escrow account, the Board would have to order a railroad to set aside such a large amount of money that it could infringe on the railroad's ability to invest in its infrastructure, ultimately damaging capacity. The Board could evaluate the financial ability of applicants to pay service-related compensation costs during its review of the merger application and set conditions for compensation on a case-by-case basis if needed.

2. <u>Service Guarantees</u>

BNSF and CN propose that applicants negotiate "service guarantees" on a shipper-by-shipper basis. BNSF Comments at 17-18, 39; CN Comments at 13. UP urges the Board to beware of this proposal. If adopted, it would endorse a growing and pernicious practice of buying shipper support for mergers -- a practice that distorts the Board's assessment of the public interest.

In normal commercial negotiations, it is desirable for railroads and shippers to negotiate service standards and guarantees. The difficulty arises when those commercial arrangements get entangled in merger politics, and railroads bargain for shipper support.

This practice is pernicious for two principal reasons. First, it favors large shippers over smaller shippers. Merging railroads may be more eager to obtain the support of a well-known shipper and therefore may be more willing to make greater economic concessions to those parties. Smaller shippers have less to "sell" in the marketplace of shipper support statements.

Second, and perhaps more important, the practice distorts the Board's public interest analysis. When support statements are motivated by undisclosed but private economic concessions, the Board has no way of knowing how to weigh, or even whether to credit, endorsements of mergers and claims of merger benefits.

The BNSF/CN approach to "service guarantees" virtually enshrines this undesirable practice. It requires shippers to negotiate one-by-one with the applicants as the only route by which they can obtain protection against service failures after the merger. This gives the merger applicants both an entrée to meet with every shipper and a significant club in demanding shipper support. Unless a shipper supports the merger, it will not obtain maximum protection against service problems and may obtain none at all.

The Board should not endorse this procedure. On the contrary, it should adopt the KCS proposal to require disclosure of all settlement agreements or other agreements. KCS Comments, pp. 44-54. Disclosure will allow the Board to make an informed judgment about a party's reasons for supporting a merger and therefore about the public interest.

D. Claims of Service Improvements

UP endorses the NITL proposal under which the Board would consider in its public interest analysis the likelihood that benefits will be achieved and the extent to which applicants stand behind their claims. NITL Comments, p. 20,

E. Passenger Service Proposals

UP agrees with Amtrak that service implementation plans should address how the applicants will avoid any new delays to passenger service. Amtrak Comments, p. 10. Amtrak requests base-line delay information, but Amtrak maintains those types of information and does not need to obtain them from freight railroads.

UP disagrees with requests of certain commuter authorities for preferential special treatment in merger proceedings. There is no reason a commuter authority should be given better treatment than a freight customer. Commuter authorities have agreements with freight railroads covering service and performance standards. and the Board should not intervene in those contractual relationships. UP would meet voluntarily with any commuter authority that wishes to discuss the affects of a proposed merger on commuter service, as we believe other railroads would, but the Board need not adopt rules to give commuter agencies unique treatment beyond their contract rights.

UP also disagrees with proposals from commuter authorities to freeze in place railroad employees who deal with commuters. See, e.g., Metra Comments. The Board should not get involved in railroad staffing decisions and railroads often cannot compel employees to stay in a specific position. Such measures would be only tangentially related to railroad mergers in any event.

The American Public Transportation Association ("APTA") urges the Board to expand commuter access to freight railroads in mergers. APTA Comments, pp. 4-5. This request is unrelated to mergers and could cause a capacity disaster for freight shippers. Commuter authorities must negotiate for use of freight lines and the authorities must help provide sufficient capacity to avoid freight train interference. Board-imposed access would undermine these relationships and could give rise to unconstitutional takings. While willing in appropriate circumstances to consider adding commuter trains to its lines, UP cannot accept such operations to the detriment of its freight customers.

Finally, UP disagrees with the Oklahoma Department of Transportation's suggestion that the Board require reasonable terms for passenger operations. Oklahoma Comments, p. 9. For the long-distance passenger trains with which Oklahoma is concerned, this requirement is redundant. Under the Rail Passenger Service Act, if Amtrak and a railroad cannot agree on reasonable compensation terms, the Board is empowered to set them.

V. Competition Issues

A. Proposals to Require Mandatory Competitive Access or Create New Competitive Alternatives

We have already discussed proposals seeking government-compelled "competition" by imposing – beyond the merger context – forced access to exclusively-served shippers. Many additional parties want to impose such access on applicants seeking a merger. See, e.g., NITL Comments, p. 15; AG Processing Comments, p. 8; Dow Chemical Comments, pp. 7-8; CURE Comments, pp. 4-5; Shell Comments, p. 9; Proctor & Gamble Comments, p. 2.

UP does not support such broad changes in the merger rules. Even if strictly limited to mergers and even if imposed only on merger applicants, broad access requirements would carry significant risks for the financial viability of the merger applicants.

The proposals are overbroad. Although some parties express concern about product and geographic competition (see DOT Comments, 14-15) and about risks to reciprocal switching arrangements (see id., p. 14 n.8; KCS Comments, pp. 54-56), the Board's existing rules already permit it to condition proposed mergers as necessary to avoid these competitive harms.

B. Proposals Relating to Horizontal ("Three-to-Two") Competition Issues

Several parties suggest that the Board establish a presumption that any transaction is anticompetitive if it reduces the number of rail options from three-to-two or even from four-to-three. See, e.g., Alliance of Automobile Manufacturers Comments, pp. 10-11; Canadian Pulp and Paper Association Comments, p. 3; Committee to Improve Coal Transportation ("IMPACT") Comments, pp. 22-25; Edison Electric Institute Comments, pp. 3-4; KCS Comments, pp. 12-14; Western Canadian Shippers' Coalition Comments, p. 3.[20]

UP believes the Board should not adopt any presumption as to the competitive impact of reductions in the number of railroads in a market. It is not true, as

20 A few parties propose rules that would impose radical remedies – such as rate freezes and massive divestitures aimed at creating new transcontinental routes – in the event a merger would reduce competitive rail options. See, e.g., Comments of AG Processing, p. 6; Edison Electric, p. 5; Greater Houston Partnership, p. 7; IMPACT, pp. 26-27; National Grain & Feed Ass'n, p. 11; Society of the Plastics Indus., pp. 8-9. It is hard to imagine any transaction ever warranting such relief, which would likely exceed the Board's authority and raise extreme implementation difficulties.

NITL suggests,[21] that all risk of *horizontal* competitive harm is behind us. Future mergers might combine the two strongest rail competitors in a market, a competitive harm. Future mergers may also adversely affect geographic and product competition by combining the two carriers that account for a significant majority of all shipments of a product and its reasonable alternatives, even if other railroads handle modest volumes of such shipments.

The Board should clarify that it will apply no presumption either way in its analysis of 3-to-2 and other merger-related reductions in the number of rail transportation alternatives. The Board should continue to apply established approach to these issues by examining them in detail based on the facts and circumstances in each particular case. In the UP/SP proceeding, for example, the parties debated the competitive effects of 3-to-2 reductions in the number of rail carriers serving many markets. In many the Board found that UP and BNSF would compete vigorously after the merger, as they have.[22] In other markets the Board concluded that SP should be replaced.

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21 NITL Comments.

22 The Board has repeatedly found that competition between UP and BNSF has been no less vigorous than pre-merger competition involving SP. See, e.g., UP/SP General Oversight, Decision No.15 served Nov. 30, 1999, pp. 5 n.15 & 6; UP/SP General Oversight, Decision No. 13 served Dec. 21, 1998, pp. 8-9 ("The UP vs. SP competition that existed prior to the merger no longer exists; but, in its place, there now exists UP vs. BNSF competition, which appears to be at least as effective as the pre-merger UP vs. SP competition.").

C. Proposals Relating to Vertical (End-to-End) Competition Issues

There is a broad consensus among commenting parties that the Board should change its analysis of the effects of "end-to-end" mergers, referred to as "vertical" effects.[23] Numerous shippers and shipper associations, government bodies, and Class I railroads, including UP, NS and CN, proposed changes. The parties focus principally on the potential of future end-to-end mergers to harm exclusively-served shippers by extending existing so-called "bottlenecks" beyond pre-merger gateways.

Some parties urge the Board to abandon its "one-lump" doctrine. IMC Global Inc. Comments, p. 6, Western Canadian Shippers' Coalition, p. 5; Western Coal Transportation Association Comments, p. 5. Others want merging carriers to maintain open gateways in various ways, or want to alter the conditions under which merging carriers must offer "bottleneck" rates in an end-to-end merger. See, e.g., AG Processing Comments, p. 6; Bunge Comments., p. 7; Dow Chemical Comments, p. 6; IMPACT Comments, p. 25; NITL Comments, p. 9.

Without endorsing all the theories and arguments expressed by these parties, UP proposed a new rule that would address all of their concerns. UP Comments, pp. 11-15. The differences between UP's proposal and other proposals relate principally to three major design parameters, each of which we discuss below:

(1) To what traffic will the rule apply?

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23 A combination of two carriers that connect with one another to provide interline transportation is "vertical" in the same sense as a merger of a manufacturer and distributor who combine their complementary capabilities to deliver a product to consumers

(2) To which gateways will the rule apply?

(3) How will the rule keep gateways open?

(1) To what traffic will the rule apply?

Any gateway preservation rule should be limited to traffic for which the proposed merger would extend an existing "bottleneck." The essential criteria are those depicted by the classic rat-tail diagram (see UP Comments, p. 11): (a) there is an existing "bottleneck" between an exclusively-served shipper facility and an interline gateway; (b) there are alternative routes beyond the gateway over which the traffic can move pre-merger in interline service; and (c) a proposed merger would convert one of the interline routes to a single-line route.

Several parties appear to contemplate a rule requiring a merged carrier to maintain gateways or quote "bottleneck rates" for movements for which two fully independent competing routes between origin and destination remain after a merger. See e.g., AG Processing Comments, pp. 6-7; BASF Comments, p. 53; SPI Comments, p. 9. In that situation, there is no "bottleneck" at all and thus no basis for concluding that an end-to-end merger involving one of the two competing routes would affect the shipper's ability to obtain competitive rates and service. Two independent routes would compete after the merger.

Likewise, there is no reason to require, as many parties implicitly suggest, that merging carriers maintain gateways or establish "bottleneck" rates for all traffic to or from existing bottleneck segments. Much of this traffic could not be affected by a merger. Accordingly, UP's rule applies only where rate and service options could be lost for a movement as a result of a merger:

"as to which no Participating Carrier served both the origin and destination of the traffic prior to consummation of the transaction but two Participating Carriers were capable of participating together in interline movements (the 'Subject Traffic')"

UP proposes adding the underscored language to make clear that the rule applies only to traffic that moved -- or could have moved -- between two carriers participating in the merger.

(2) To which gateways will the rule apply?

The Board should reject proposals to require applicants to quote "bottleneck" rates via the "first junction in the direction of the other end of the movement." See, e.g., SPI Comments, p. 10; Subscribing Coal Shippers Comments, pp. 21-22. Instead, the Board should preserve the principal interline route used to handle the traffic before the merger. Any other rule would alter existing shipping patterns, promote less efficient routes, and create new short-haul routes rather than preserving meaningful options affected by a merger.

A "first-junction" rule would deprive the "bottleneck" carrier of its pre-merger long-haul route, eroding the applicant's pre-merger revenue base as a price of merging. Moreover, opening new gateways would force a complete redesign of the carrier's transportation plan, fragment traffic flows, and potentially require additional inefficient switching. This could lead to a service reduction for traffic on the new routes. See, e.g., Traffic Protective Conditions, 366 I.C.C. 112, 124 (1982); CSX/NS/Conrail, Decision No. 89 served July 23, 1998, pp. 76-77. It also would make it impossible for the Board to compare pre-merger and post-merger service levels.

We recognize the need to make a minor adjustment to the rule we proposed in our initial comments to deal with situations where traffic can efficiently flow over two different but geographically proximate gateways. Ameren's comments reveal the problem. Ameren describes two principal interline routes for coal traffic from the Powder River Basin to Ameren's power plant at Newton, Illinois, which is served exclusively by CN/IC: a BNSF-CN/IC route via Centralia, Illinois (a gateway not served by UP) and a UP-CN/IC route via Tuscola, Illinois (a gateway not served by BNSF). A BNSF/CN merger could extend the existing CN/IC "bottleneck" segment beyond the Centralia gateway, but CN/IC connects with no other carrier at the Centralia gateway. It cannot keep that gateway open. To avoid extending its "bottleneck," CN must keep a *different* gateway (Tuscola) open. Accordingly, we revise our proposal to require a merged carrier to establish separately challengeable "bottleneck" rates to the principal, geographically proximate gateway that serves as the alternative for the merging carriers' gateway.[24]

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[24] To achieve this change, a new section could be added to UP's proposed rule to establish that geographically proximate alternative gateways can be treated as "Pre-Transaction Gateways" for purposes of the rule, even though they are not served by both merger participants:

> "(f) If there is no Pre-Transaction Gateway as defined in section (a)(1) because the interchange point between Participating Carriers used most frequently was not served by another carrier capable of participating in the traffic on an interline basis, then the Pre-Transaction Gateway shall be the reasonably proximate alternative interchange point between the Participating Carrier and a carrier not participating in the transaction as a Primary Applicant (an "Alternate Gateway") that, during the twelve months preceding the pre-filing notice under 49 C.F.R. § 1180.4(b) pertaining to the transaction, was (i) the Alternate Gateway used most frequently to handle the Subject Traffic, and (ii) used by at least 100 cars of traffic originating or terminating at the Exclusively-Served Shipper Facility."

It is sufficient and even desirable to keep just one efficient gateway open for each flow of interline traffic affected by the merger. Just because a particular gateway between the merging carriers was used for certain traffic before the merger does not necessarily mean that it is the most efficient gateway for all traffic flows. As a general rule, the rail system can provide more efficient and faster service by concentrating traffic on fewer routes. It would not be efficient to preserve as an "open gateway" every possible point of interchange that existed between two merging carriers, no matter how lightly used.

(3) How will the rule keep gateways open?

The parties have struggled to find meaningful ways to keep gateways open without returning to the discredited "DT&I" conditions. Some parties vaguely support keeping gateways open but do not explain how. Other parties propose new forms of rate regulation that are clearly unacceptable. For example, some would require merging carriers to freeze existing joint-line rate levels, in some cases subject to annual indexing. See Greater Houston Partnership Comments, p. 7; DOT Comments, p. 14. Others would bar rate discrimination against interline routes by requiring rates to the gateway to be set "on a proportionate or a mileage basis to the rates being offered in through [i.e., single-line] service." SPI Comments, pp. 8-9. Apart from the obvious jurisdictional questions these proposals raise,[25] the proposals effectively jettison the rate-setting freedoms granted by the Staggers Act.

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[25] The Board lacks maximum rate jurisdiction over contract rates, which represent a majority of all rate offerings in today's marketplace, see, e.g., Bottleneck I, and rates below 180% of viable costs, see, e.g., FMC Wyoming Corp. v. UP, Finance Docket No. (continued...)

The ability to adjust rates to reflect market conditions, including the relative efficiencies of various routing alternatives, is vital to achieving an efficient rail transportation network. Railroads must have the freedom to set rates that reflect costs and efficiencies of individual routes and services. For this reason,[26] the Board abandoned the rate equalization requirements of the "DT&I" conditions, and it should refrain from re-adopting restrictive and inefficient new forms of rate regulation in this proceeding.[27]

UP's proposal avoids these problems by preserving the "bottleneck" carrier's rate flexibility. Rates would be constrained by competition or, in its absence, established standards for rate reasonableness.

VI. Shortline Issues

UP favors revisions to the Board's rules that would address the effects of future mergers on shortlines. UP's proposals for service remedies and "bottleneck" rate conditions would apply to shippers served by a merging railroad's shortline connections and therefore would benefit the shortlines as well as their shippers. They

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33467, Decision served Dec. 16, 1997; Rail General Exemption Authority, I.C.C. Ex Parte No. 346 (Sub-No. 35), Decision served May 16, 1995.

26 See, e.g., Traffic Protective Conditions, 366 I.C.C. 112, 123-26 (1982); CSX/NS/Conrail, Decision No. 89 served July 23, 1998, p. 77 ("Freezing agreements, rates, and routes would prevent efficiency enhancing changes that benefit shippers. The ICC once pursued a policy of freezing routings, gateways, and rate relationships, but this policy was not in the public interest, and we will not reinstitute it here").

27 For the same reasons, UP opposes the proposals of various ports to require merging carriers to equalize rates and services among the ports they serve (see, e.g., Port of Houston Authority Comments, p. 11), and the proposals of some parties that would require equalization of grain and other rates between the United States and Canada (see, e.g., North Dakota Public Service Comm'n Comments, pp. 7-9). These proposals would resurrect discredited rate principles that have been abandoned for decades. See, e.g.,

(continued...)

would supplement existing precedents that protect shortlines from losing one of their two Class I connections and from extension of existing "paper barriers."[28] UP favors rules that codify those basic principles.

Most of the shortline proposals however, have nothing to do with the effects of mergers.[29] Proponents of the so-called "shortline bill of rights" want to eliminate all "paper barriers," bar "discrimination" against shortlines with respect to rates, and require financial assistance to upgrade shortlines' track structure to accommodate heavier-loading equipment.[30] These pre-existing issues are being debated outside the realm of mergers and are not affected by mergers. The Board has repeatedly held that there is no connection between mergers and requests by shortlines for relief from "pre-existing conditions."[31] It would be inappropriate for the Board to impose

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Traffic Protective Conditions, 366 I.C.C. 112, 130-31 (1982) (Staggers Act inconsistent with rate equalization and other rigid rate regulatory standards).

28 See CSX/NS/Conrail, Decision No. 89 served July 23, 1998, pp. 76-77 (Board "practice ... to impose conditions, where feasible, to preserve a second connection" for 2-to-1 shortlines and to "prevent[] blocking provisions ... from having greater force as a result of a merger").

29 Many of the proponents of regulatory change benefiting "shortlines" are in fact large Class II regional railroads, such as Montana Rail Link, IMRL, and DM&E. Railroads which have annual revenues in excess of $20 million are for the most part not similarly situated to the smaller Class III railroads customarily regarded as "shortlines." 49 C.F.R. § 1201.1-(1)(a).

30 See, e.g., Comments of ASLRRA, pp. 7-8; Eastern Shore R.R., p. 4; Finger Lakes Ry., p. 4; Iowa Traction R.R., p. 3; State of Maryland, pp. 8-9; Ohio Rail Development Comm'n, p. 7.

31 The Board has repeatedly concluded, for example, that, except where a merger renders a shortline captive or creates or extends a "paper barrier," there is no link between mergers and contract limits on interchange. UP/SP General Oversight, Decision No. 13 served Dec. 21, 1998, p. 11; see also CSX/NS/Conrail, Decision No. 89 served

(continued...)

burdensome regulatory requirements on carriers solely because the carriers are seeking merger approval.

Class I railroads are already committed to addressing "paper barriers" and related concerns. At the urging of the Board in Ex Parte No. 575, Review of Rail Access and Competition Issues, the railroad industry has a formal process for resolving concerns regarding "paper barriers" and other issues. The "Railroad Industry Agreement" ("RIA") between the AAR (representing Class I railroads) and the ASLRAA (representing shortlines and Class II railroads) commits Class I railroads to waiving interchange limitations for new traffic and to considering the renegotiation of any sale or lease agreement that includes contractual limits on interchange as long as the smaller railroad compensates the Class I carrier for lost traffic.[32] Further discussions between the AAR and ASLRRA are underway concerning potential modifications to this agreement to address lingering concerns of some ALSRRA members, particularly the larger Class II members. See UP Comments, p. 16. The Board has repeatedly declined to "circumvent the process established in the [RIA],"[33] and it should similarly decline to do so here.

July 23, 1998, p. 77 (not "appropriate for us to require wholesale elimination of these freely negotiated contractual terms as part of this proceeding"); RailAmerica, Inc. – Control Exemption – RailTex, Inc. ("RailAmerica"), Decision served Jan. 10, 2000, p. 6 (rejecting effort to remove "paper barriers" as seeking to "use the Board's oversight process as a means of altering preexisting conditions"); CN/IC, Decision No. 37 served May 25, 1999, p. 39; Finance Docket No. 33813.

32 To date, no shortline or regional railroad has asked UP for expanded rights under the RIA. Verified Statement of Warren Wilson, p. 7. (Exhibit 2 hereto).

33 RailAmerica, p. 6; see also UP/SP General Oversight, Decision No. 13 served Dec. 21, 1998, p. 11; Review of Rail Access and Competition Issues, STB Ex Parte No. 575, Decision served Mar. 2, 1999.

Proposals to eradicate existing "paper barriers" warrant further comment, because, in addition to lacking any relationship to mergers, they rest on fundamentally misleading premises. Warren Wilson, UP's Senior Manager of Rail Line Planning and the UP official principally responsible for UP's shortline relationships, describes he pertinent facts in his accompanying Verified Statement.

As the Board has described, "paper barriers" are "contractual provisions constraining the ability of a small railroad to interchange traffic with carriers other than the carrier from which its lines were originally purchased." UP/SP General Oversight, Decision No. 13 served Dec. 21, 1998, p. 11 n.36. Numerous parties recommend that the Board adopt regulations sweeping away these contractual provisions. Some propose that, in future Class I merger proceedings, all contractual limits on interchange involving a Class I applicant should be eliminated automatically as part of the merger review process. See, e.g., ASLRRA Comments, p. 7; DM&E Comments, p. 7. Others propose that such contractual provisions should be subject to a "presumption" favoring elimination or some other form of "strict scrutiny." See, e.g., State of New York Comments, pp. 15-17; NITL Comments, pp. 20-21.

Despite the derogatory nickname, "paper barriers" are legitimate contractual provisions negotiated between the shortline and the Class I. They are not forced upon unwilling shortlines. Instead, they allow shortlines to exist and reduce the burdens of owning and operating a shortline railroad. As Mr. Wilson explains:

1. The contractual relationships between Class I railroads and smaller railroads are not uniform. Some shortlines purchased their lines from a Class I railroad years ago, while others did not. For example, most of the shortline connections that were

"spun off" from UP's system involve leases, not purchases. In those situations, UP still owns the lines the shortlines operate. See Wilson V.S., p. 3. The Board must recognize these differences in considering proposed rules.

2. Many agreements between Class I railroads and shortlines contain no prohibitions on interchanging traffic whatsoever. For example, UP's shortline leases permit the shortline to interchange with any other connecting carriers. The shortline has the choice of paying its rental obligation to UP either in traffic (by interchanging traffic with UP instead of other railroads) or in cash. The shortline may choose to interchange no traffic with UP as long as it pays UP its rent in cash. Id., p. 4.

3. These lease arrangements benefit shortlines. The shortline's agreement to pay the lease in traffic rather than cash allows the shortline to avoid up-front financing costs, charge lower rates to its shippers, devote its financial resources to upgrading the line, and generate additional traffic. The shortline also bears less risk, since it can discharge its "rent" obligation with a percentage of its interline traffic, rather than a fixed monthly or annual cash payment. Similar benefits flow from contractual interchange commitments that allow a shortline to purchase a line for a lower purchase price. Id., p. 4. For these reasons, DOT opposes rules that would permanently remove "paper barriers": it recognizes that such provisions "are contracts that the buyer of a small carrier entered into with the selling Class I carrier *for favorable terms at the time of purchase*." DOT Comments, p. 21 (emphasis added).

4. Many shortlines would not exist today if the Class I carriers could not have entered into contracts – at arm's length – allowing the shortlines to pay for their

acquisition in traffic rather than cash. The shortlines would not have been able to finance the higher purchase price or would have had higher costs.

5. Eliminating "paper barriers" would be a one-sided renegotiation of the terms of the shortline's acquisition. Some parties are quite explicit in calling for a Board examination of whether the Class I carrier has already received a "reasonable" economic return for the use of its lines. See State of New York Comments, p. 17; NITL, pp. 20-21; Subscribing Coal Shippers Comments, pp. 22-24. There is no statutory authority for the Board to second-guess the economic valuations arrived at through negotiations between the parties.[34] At a minimum, the Class I must have the option of rescinding the transaction if the Board attempts to restructure its contract.

VII. Public Benefits

Numerous parties, including UP, urge the Board to require applicants to establish with greater certainty that a merger provides public benefits. E.g., DOT Comments. We support this higher standard of proof, because prior mergers have absorbed the excess capacity from which railroads suffered two decades ago, because the risks associated with Class I mergers are substantial, and because the case for efficiency benefits from additional Class I mergers is weaker than in the past. We therefore join

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[34] Except in the narrow circumstances to which the ICCTA's "feeder-line" provisions apply, see 49 U.S.C. § 10907(b)(1), the Board lacks authority to compel the sale or lease of a line to form a shortline, and thus cannot compel a Class I carrier to engage in such a transaction on financial terms that the Class I regards as unacceptable. Even in the case of feeder line sales, the line's owner must receive a price "not less than the constitutional minimum value" of its assets, which is the greater of the line's going concern value and its net liquidation value. 49 U.S.C. § 10907(b)(1) & (2).

those who urge the Board to test benefit claims to determine whether the benefits are substantial and whether they are likely to be achieved.

Because achieving public benefits through inter-carrier cooperation has become easier as a result of recent developments, merger applicants should now prove that permanently restructuring the North American rail system is necessary to generate benefits. With fewer Class I carriers, conflicting perspectives are less likely to interfere with cooperation. Vastly improved information systems allow railroads to exchange data in ways that were impossible only a year or two ago, supporting interline service and other initiatives. New e-commerce initiatives promise to revolutionize the industry.

Recent news reports provide compelling evidence of the new opportunities for inter-carrier cooperation. Less than one month ago, BNSF and NS announced a remarkable, multi-railroad enhancement of transcontinental intermo[illegible] service. BNSF News Release 958, 5/10/00. According to BNSF, the agreem[illegible] "first truly integrated operating agreement between BNSF and NS." [illegible] the agreement will provide expedited intermodal service between Atlanta, Charlotte, and Jacksonville on NS and California and Arizona locations on BNSF. We understand that the parties intend to expand this agreement to include service between the Southeast and other points in the West. In addition, NS will purchase 1,300 new containers, which it will contribute to the North American Container System, a ten-railroad consortium that furnishes equipment for a doublestack container network spanning the entire North American continent as far north as Halifax and Prince Rupert and as far south as Mexico City.

CN is also proposing a major market extension using three-carrier interline service. It recently announced plans to develop intermodal service to and from a facility in New Stanton, Pennsylvania, southeast of Pittsburgh, targeting shippers within a 150-mile radius. CN will provide this service next year in connection with Wheeling & Lake Erie and the Southwest Pennsylvania R.R.

In view of the rapid pace of change in the industry, the Board should recognize as public benefits only those improvements that can practicably be achieved only through merger. We do not suggest that merger applicants must prove that they actually tried and failed to achieve through cooperative efforts each of the public benefits they claim, although such experiences would be useful evidence. Applicants must, however, explain the factors that make it unlikely the benefits will be achieved through inter-carrier cooperation. Evidence that other railroads have achieved specific types of benefits without merging should establish a presumption that applicants' claimed benefits are not attributable to their merger.

UP sharply disagrees with CN's remarkable assertion that a merger generating no public benefits should nevertheless be approved as "consistent with the public interest." CN Comments, p. 45. The Board should reject this extreme view for a number of reasons:

- First, service problems have followed every major railroad merger in recent years (the modest CN/IC transaction is not fully implemented).[35] Because service disruptions are so

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[35] Although less disruptive than the service failures following UP/SP and the Conrail division, the BNSF merger caused a three-year service decline according to major BNSF shippers such as UPS and General Motors. Statement of United Parcel (continued...)

likely to follow Class I mergers, a merger with no public benefits must be judged contrary to the public interest.

- Second, by reducing the number of large railroads, future Class I mergers would expose the national rail systems to new risks. For example, a poor management team at a transcontinental railroad could cause grievous injury that would be difficult to remedy. As DOT told the Board, such mergers might be "too large to manage but too large to fail." Another example is that the reduced population of Class I railroads might be less likely to innovate. These concerns associated with increased size and reduced diversity should also defeat a merger with few or no public benefits.

- Third, a merger with no public benefits would increase the pressure for devastating re-regulation of the railroad industry.

VIII. Miscellaneous Proposals

A. Changes in Accounting Rules

Several parties ask the Board to exclude so-called "merger premiums" from carrier costs in rate proceedings and other regulatory contexts. E.g., NITL Comments, p. 18; Subscribing Coal Shippers Comments, pp. 17, 24-25, 157. The "merger premiums" are, of course, the actual costs railroads incur in acquiring other railroads and achieving the benefits of mergers.

This request has been litigated recently on the basis of elaborate records, and the Board rejected it. Docket No. 42022, FMC Wyoming Corp. v. Union Pacific R.R., Decision served May 12, 2000, pp. 10-11; Finance Docket No. 33726, Western

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Service, Inc., Feb. 29, 2000, p. 3; Statement of General Motors Corporation, Feb. 29, 2000, p. 3.

Coal Traffic League v. Union Pacific R.R., Decision served May 12, 2000. There is no reason for the Board to reconsider those decisions here.

B. Expedition of Rulemaking

To expedite consideration of its proposed consolidation with CN, BNSF asks the Board to truncate this rulemaking and issue final rules within four to six months. BNSF Comments, p. 3 and n.1.[36] UP urges the Board to take the time it needs to consider carefully the more than 100 comments already filed and the additional responses it will receive today.

UP objects to BNSF's suggestion that reply comments on the Notice of Proposed Rulemaking be filed only 15 to 17 days after opening comments. Even with its substantial resources, UP found it difficult to review the thousands of pages of comments filed on May 16, much less to develop thoughtful responses and gather probative evidence. Smaller parties with fewer resources will need still more time. UP also urges the Board not to dispense with rebuttal comments on these momentous rules, potentially the most important rules to be established since passage of the Staggers Act.

C. Restrictions on Railroad Intermodal Policies

The Board should reject the Transportation Intermediaries Association's ("TIA") attempt to involve the Board in intermodal transportation issues that have nothing to do with mergers. TIA's requests are designed to protect the role of certain Intermodal Marketing Companies ("IMCs") against competing intermodal marketing

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[36] The U.S. Department of Transportation ("DOT") asks the Board to act "before its self-imposed deadline of 15 months," but makes no concrete proposals. DOT Comments, p. 2.

options, but there is no public interest in protecting these entities. The intermodal market functions well, and there is no reason to believe that shipper interests require the Board to insulate certain types of agents from market forces.

TIA asks the Board to review merging carriers' policies regarding the terms and conditions on which they do business with IMCs, including minimum volume contracts, bonding requirements, and equipment allocations. TIA also urges the Board to prohibit "discrimination" against smaller IMCs. In substance, TIA wants the Board to interfere in the complex interaction of railroads and IMCs by re-regulating aspects of exempt intermodal transportation.

These interactions are far more complex than TIA acknowledges. As TIA's comments reflect, BNSF is more aggressive than UP in establishing requirements for IMCs, but BNSF continues to do large and growing amounts of business with smaller IMCs that do not meet its requirements. In order to replicate the efficiencies of larger IMCs, smaller IMCs have formed consortia that purchase transportation services from the railroads. These consortia, scarcely mentioned in the TIA comments (TIA acknowledges that IMCs sometimes "combine contracts"), meet the most stringent railroad requirements and qualify for railroad incentive programs. This is evidence of an efficient marketplace at work, not of market power.

D. Use of Voting Trusts

Some parties recommend that the Board revise its procedures governing voting trusts, which are often used to insulate a railroad from unlawful control by a purchaser while the Board considers a merger. The Port Authority of New York and New Jersey ("PATH") recommends that the Board require detailed financial information from carriers before it approves any voting trust. PATH Comments, p. 14. The Ports of

Seattle, Tacoma, and Everett recommend that the Board adopt "guidelines" that would essentially prohibit the use of voting trusts for mergers. Washington Post Comments, pp. 17-18. The rationale for these proposals is to ensure that the Board's approval of a voting trust does not result in de facto approval of the essential financial terms of the proposed transaction.

No change in the Board's voting trust procedures is needed. The Board already has the ability to review proposed voting trust agreements to ensure that they will protect the independence of a carrier during review of a proposed transaction. If a voting trust arrangement would preclude the Board from engaging in a meaningful review of the transaction, the Board can disapprove it. See generally Finance Docket No. 32619, Union Pacific R.R., et al. – Request For Informal Opinion – Voting Trust Agreement, Decision served Dec. 20, 1994.

The proposed changes could encourage hostile takeovers of railroads by non-railroads. Limiting use of voting trusts would uniquely handicap rail carriers in the market for corporate control of other rail carriers, since non-carriers pursuing the acquisition of a carrier can complete their acquisition without Board approval. If the voting trust mechanism were unavailable, for example, carriers might be disabled from stepping in to prevent a non-carrier from raiding the assets of another carrier, as occurred when UP and Blackstone Partners (which controlled several small carriers) stepped in to rescue CNW from a hostile bid by Japonica Partners.[37] Blackstone established a voting

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[37] The Japonica bid led the ICC to take the extraordinary step of convening a separate proceeding – Ex Parte No. 480, Chicago & North Western Transportation Co. – Transportation Ramifications of Acquisition By Japonica Partners, Decision served May (continued...)

trust in order to carry out its acquisition of control of CNW.[38] With railroads stocks trading at low levels, corporate raiders and other non-carrier investors should not be given a further advantage over carriers.

E. Use of Confidentiality Designations

UP supports proposals by several parties to limit the abuse of confidentiality designations under Board protective orders. Merger applicants and other participants in a merger proceeding sometimes unnecessarily restrict access to information that is vital to evaluating the effects of a proposed transaction. See PATH Comments, p. 12; NS Comments, p. 68. Analysis of the operating, competitive, and other effects of proposed mergers or requests for conditions should not be the sole province of paid outside consultants. Except to the extent that information is of the utmost competitive sensitivity – e.g., the confidential terms of shipper contracts, internal strategic planning documents, and rates-applicants should not use "Highly Confidential" designations to bar disclosure of information to party employees who have agreed, by executing the Board's standard "Confidential" undertaking, to be bound by a protective order.[39] UP believes that the Board should take this opportunity to establish more appropriate parameters for the use of "Highly Confidential" designations.[40]

2, 1989 – to consider the "transportation ramifications" of the attempted Japonica takeover of CNW, but the Commission acknowledged that it likely lacked jurisdiction over the proposed takeover.

38 Blackstone Capital Partners L.P. – Control Exemption – CNW Corp. & Chicago & North Western Transportation Co., 5 I.C.C. 2d 1015, 1016 n. 5 (1989).

39 The Board can act to require de-classification of material of central importance in a particular case. See, e.g., CN/IC, Decision No. 31 served Feb. 12, 1999 (requiring submission of public record version of CN-IC-KCS Alliance Agreement and CN-KCS (continued...)

Respectfully submitted,

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June 5, 2000

Access Agreement). In the ordinary case, however, it is often too burdensome and time-consuming to litigate the treatment of large numbers of documents. Over-designation thus often goes unchallenged.

40 The most serious abuses have been in rate cases, where some shippers have designated their entire filings as "Highly Confidential," even though they contain little or no sensitive material.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 5th day of June, 2000, a copy of the foregoing "Union Pacific's Reply Comments" was served by regular mail, postage pre-paid, or a more expeditious manner of delivery on all parties and non-parties of record to this proceeding.

J. Michael Hemmer

J. Michael Hemmer

EXHIBIT 1

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED STATEMENT

OF

WILLIAM J. BAUMOL

Qualifications

My name is William J. Baumol. I reside at 45 Ocean Avenue, Monmouth Beach, New Jersey, 07750, USA. I am professor of economics and Director of the C.V. Starr Center for Applied Economics at New York University. I received my bachelor's degree in economics from the College of the City of New York in 1942 and my Ph.D. from the University of London in 1949. After my military service in Europe during World War II, I taught at the London School of Economics from 1947 through 1949. I then served as a member of the faculty of Princeton University for 42 years, where I recently became professor emeritus, and where I still hold an appointment as Senior Research Economist. I have written approximately 30 professional books and 500 articles. I have served as president of four leading professional organizations of economists including the American Economic Association, the world's largest organization of economists from business, government, colleges and universities. I hold nine honorary degrees and other honors in the United States and abroad, and am a member of three of the nation's leading honorific societies, including the National Academy of Science.

I have taught university courses on the economics of antitrust, regulation and industrial organization, and have been invited to lecture on these subjects in forums throughout the world, most recently in Australia, France, Israel, Italy, England and Venezuela. I have also written a number of articles and books related to these subjects and have testified extensively on antitrust and regulatory issues before courts and regulatory agencies in the United States and abroad. Over almost forty years, I have been involved in matters relating to regulation of railroads in the United States.

The Issue and My Conclusions

The Board's request in Ex Parte No. 582 for comments on the appropriate rules governing future Class I mergers has been seized upon by some of the largest and most affluent shippers and their trade associations (henceforth I will refer to them as "the Access-Seeking Shippers") as an opportunity to re-impose regulations of railroad rates that are designed in the spirit of the pre-Staggers era. I address in this statement proposals by a number of parties that the Board adopt rules compelling merging railroads (and in some cases even non-merging railroads) to provide competing railroads with access to their exclusively-served shipper facilities, via mandatory switching in terminal areas, grants of trackage rights, or requirements to establish separate challengeable rates for existing bottleneck segments. I will refer to all of these proposals as seeking "forced access."

Those who advocate the forced access rules make little effort to conceal their objective -- the imposition of regulations that would lead directly to lower transportation fees that, in turn, would result in further erosion of the railroads' persistently inadequate earnings. They ignore the inevitable effect in terms of deterioration of the rail network, and the resulting undermining of service quality and service provision. They repeatedly claim that their objective is to enhance competition and to turn to the market rather than to regulation as the determinant of railroad decisions and activities, when they demonstrably mean the opposite. They repeatedly refer to railroad "monopoly profits" when they know full well that railroad rates of return persistently fall below the levels earned in the economy's other industries, many of which are manifestly competitive and subject to the control of the unconstrained market.

Decades of ill-advised regulation and the persistent inadequacy of rail revenues, for which regulation bore heavy responsibility, led to drastic under-investment in the rail network. While the Staggers Act of 1980 had a beneficial effect on infrastructure investment, further improvement in the rail network has manifestly been held back by the inadequacy of railroad earnings. The shippers who are participating in this rulemaking and using the merger issue as an excuse to advocate re-regulation through regulatory intervention apparently do not recognize that the changes they propose must in the long run be damaging to all or virtually all those affected, *including themselves*.

The forced access proposals appear to promise stimulation of competition by the imposition of access, on what amounts to uncompensatory terms, to the properties of the railroads. But this will simply constitute a subsidy of competitors regardless of their efficiency and a transfer of funds from the railroads to the shipper proponents of forced access. It will be a tilting of the playing field that undermines competition, while having the appearance of promoting it.

It has been argued that imposed access will help to prevent breakdowns in service quality by giving others access to a railroad's bottleneck facilities, with rival carriers striving for business through improved service quality. But those who argue this way do not realize that their remedy can only bring on the disease it is ostensibly designed to cure. By further undermining efforts to achieve adequacy of revenues, the proposed changes will prevent the railroads from obtaining the funds for the very investments needed to prevent service deterioration. And after rail operation is turned into an activity whose earnings are even further behind those of U.S. industry generally, who will really want to compete for the privilege of carrying even more money-losing traffic?

The Competitive Capital Markets and the Importance *to the Economy* of Adequate Rail Earnings

Avoidance of regulatory imposition of access requirements that will inevitably lead to inadequate railroad earnings is not simply a matter of legal requirements and justice in the treatment of investors. Rather, the economy itself stands to lose an essential part of its infrastructure if indefensible reregulation further reduces railroad earnings. The economy's capital markets are highly competitive, and investors are under no compulsion to provide financial resources to any enterprise that does not promise a level of earnings commensurate with those currently offered by others who are in the market for funds. That is why adequacy of earnings in any industry, from the viewpoint of economic efficiency, is only legitimately measured by reference to the earnings currently obtained in other industries. And in these terms it is easy to demonstrate that while rail earnings have improved since adoption of the Staggers Act, they have nevertheless remained persistently and substantially below adequate levels.

Experience in rail transportation in the wake of the Staggers Act should convincingly demonstrate that in this industry achievement of adequate revenues is no easy matter. The governing statute enjoins regulators to refrain from measures that prevent the achievement of adequacy of earnings by the railroads. Regulators, indeed, have clearly tried to live up to this admonition. And, in fact, in the post-Staggers era, the railroads have progressed markedly toward the goal of adequate revenues, doing so, it should be noted, with the aid of steadily *declining* real rail rates. *But the fact is that rail earnings remain well below those of most other industries.* So long as the railroads remain unable to offer investors returns as attractive as those investors can obtain elsewhere, they will be severely constrained in their ability to obtain the investment resources they need to serve those who now demand imposed access, as well as others. In other words, in the pertinent sense of the term, rail revenues must be deemed to continue to be inadequate.

This means that investors can be relied upon to vote with their feet. That is, if rail revenues are cut further investors may well refuse to provide railroads with the funds necessary for maintenance, replacement, modernization and (where needed) expansion. Alternatively, the investors will supply funds only on terms that are unsustainable from rail earnings alone and can only be financed by, in effect, giving away the railroads' assets. Moreover, if measures are taken that will further reduce these revenues it will clearly be management's responsibility to investors to refrain from pouring good resources after bad and to seek, on the contrary, to reduce the resources tied up in rail investment.

The effect on rail service should be obvious. The damage will be felt most severely by the shippers located on the less heavily utilized portions of the network that would be the first, but not necessarily the last, casualties of inadequate investment. These (usually smaller) shippers, in contrast, by and large, are not directly represented in this proceeding but with whose interests the large Access-Seeking Shippers are ostensibly concerned. However, even though smaller shippers may suffer first, in the long run even these large shippers will bear the consequences of their proposals, and the resulting deterioration in the amount and quality of service that the railroads will be able to provide to them will, so to speak, constitute the punishment that fits the crime.

How to Ensure Continued Inadequacy of Railroad Returns

The proposals of the Access-Seeking Shippers are clearly likely to make it impossible for the railroads to recover their substantial sunk, fixed and common costs. The proponents of forced access seek access in order to reduce the total amount they pay for transportation, and thereby to reduce the revenue contribution that an incumbent can receive from its ownership of a bottleneck facility. But in a market where competition limits the price railroads can charge for most of their traffic, any artificial reduction in the revenues obtained from movements for which regulation provides the upper bound on rates simply must reduce the railroads' total revenues. Stated differently, on fully competitive sections of a route rivalry forces rates downward toward variable costs because any supplier will be unwilling to forego a contribution to its fixed and common costs, however small. So from these segments only a minor portion of those costs can be recovered, leaving the rest to be obtained from the bottleneck portions of the route -- the only place they are available. The regulatory ceiling on end-to-end rates then ensures that no more than the appropriate amount is recovered from the bottlenecks. Thus, forced access in the railroad industry -- which by definition would undermine railroads' ability to price differentially -- could not be more threatening to the prospects for adequacy of railroad investment.

The railroads, like other industries, must obtain revenues not only sufficient to cover their variable or incremental costs, but also their extensive fixed and common costs, notably the costs of track maintenance and improvement. If the forces of competition prevent the earning of more than variable costs on the non-bottleneck portion of a railroad's facilities, it is only through its earnings on bottleneck facilities that it can hope to cover its fixed and common costs. The calls for imposed competitive access at regulated prices for bottleneck service are thus a direct challenge to differential pricing. Differential pricing is uniformly acknowledged to be a critical requirement for financial viability of the railroad industry. This is a direct consequence of the fundamental economics of railroading, with its high fixed and common costs and the presence of competition in most of the network. The shippers generally do not challenge differential pricing openly, since its logic and reasonableness are so widely recognized. Instead, they call for price ceilings on the portions of the railroads' services where fixed and common costs can be recovered. These ceilings are tantamount to the elimination or the imposition of severe constraints upon differential pricing, preventing continued recovery (with no excess profits) of any of the railroads' fixed and common costs.

In sum, despite the rational regulatory policies under which railroads now operate, they have for many decades been unable to achieve rates of return anywhere near those of the many other industries with which they compete for investment funds. It is little short of a miracle that, despite this, in the post-Staggers era the railroads have been able to carry out as much investment as they have. Looked at from the point of view of investor incentives, it should hardly be surprising that there have been some breakdowns of service quality. The surprise, rather, should be that despite persistently substandard rates of return, service and capacity problems have been so rare.

Will Competition Really Be Promoted By Forced Access To Bottleneck Services At Uncompensatory Rates?

Ironically, one point repeatedly made by Access-Seeking Shippers is that their aim is to substitute market discipline for regulation as the means to constrain the behavior and decisions of the railroads. The Access-Seeking Shippers do, indeed, emphasize their dedication to substitution of market forces for regulation. Thus, for example, in the Opening Comment of PPL Electric Utilities Corporation and PPL Montana LLC, "major benefits" are ascribed to "an approach emphasizing market discipline, in contrast to public utility-style ratemaking..." (pages 15-16). Yet the Comments submitted by The Fertilizer Institute refer to "the possibility of requiring merger applicants to provide switching at an agreed-upon fee", noting that "TFI supports this change." (page 4). Similarly, the comments of Dow Chemical Company tell us that "Dow encourages the Board to consider [permitting shippers] to apply to the regulatory agency to set a rate for traffic over the bottleneck railroad serving the shipper to an interchange point with another railroad." (page 8). This is indeed a desire for deregulation through reregulation.

Far from creating marketplace competition where there is none today, the kind of forced access requirements that are proposed in this proceeding would subsidize the entry of less efficient railroads. New entry via forced access under these conditions would not result in any *real* addition to competition in the industry. Clearly, with inadequate returns to the industry, no one is about to construct new competitor rail lines, particularly under the proposed new rules that would further reduce earnings opportunities. Unlike the entry of new electricity generators who bring new facilities with them or the development of new gas fields that were previously untapped, imposed access in the rail industry is not even *intended* to lead to construction of new railroad lines or new facilities in bottleneck areas. Also, there is no major new railroad technology or new low-cost operating technique whose utilization would be promoted by forced access. Nor would these rules lead to the entry of new barge lines or trucks that are a prime source of competition in surface transportation.

What type of new entry is, then, sought by proponents of imposed access in the railroad industry? It is forced, subsidized entry that, wholly apart from its devastating effects on the earnings of the incumbent railroads, would lead to inefficient results that would never persist in any effectively competitive market.

Under the existing regulatory regime, bottleneck rates are not unconstrained. Under the existing rate reasonableness regime, railroads are prevented from earning too much through their bottleneck facilities under the principles of Constrained Market Pricing, which prevent the railroads from charging origin-to-destination rates, *inclusive of service on the bottleneck portions of their service,* that exceed competitive standards. The basic reason for placement of a ceiling only on end-to-end rates is straightforward. That end-to-end rate is the amount the customer actually pays, and it is what should matter for the shipper who is dedicated to the competitive market model for rate regulation. Under these circumstances, a change in the price of a component is as irrelevant as a change in the sticker price of an automobile transmission, when the price of the automobile remains fixed at $20,000. Or rather, it remains irrelevant unless an association of auto transmission repair shops persuades regulators to place a $10 ceiling on the price of transmissions and then demands that the car manufacturer supply the shops with transmissions alone, at their newly regulated price. That is precisely what the shippers are after here. They seek to impose uncompensatory price ceilings on bottleneck service in isolation, patently planning to purchase bargain bottleneck service and no more from the affected railroads.

Under current origin-to-destination regulation of railroad rates based on the competitive market model, the owner of a bottleneck facility has strong incentives to let a more-efficient provider handle traffic that moves over the bottleneck at a compensatory fee beneficial to both parties. The owner of the bottleneck can maximize its net revenue from the origin-to-destination movement only by avoiding any wasted costs that it might incur by handling the traffic itself, if another carrier can do so more efficiently. Therefore, as in any competitive market, the bottleneck owner has the incentive to make efficient "make or buy" decisions -- *i.e.*, to provide the service itself if it can do so efficiently, or to "buy" the service from a more efficient supplier.

Two conclusions follow from this discussion. First, if regulators set an access charge for the bottleneck alone -- *i.e.*, a switching fee the carrier may not exceed when it provides compulsory switching to the exclusively-served plant, a trackage rights charge the carrier may not exceed when it is forced to allow the competitor to operate over its lines to serve the exclusively-served shipper, or the rate factor it may not exceed when it is compelled to set a separate rate for the bottleneck segment -- below the level called for by the competitive market model, it would not increase competition, but simply would amount to a cross-subsidy that allows less efficient providers to take business away from a more efficient competitor. Second, if regulators set access charges at a level that ***does not*** distort competition between the bottleneck owner and its competitors, a forced access regime would not result in any changes in the way traffic is handled today. The current regime already gives the owner of a bottleneck facility the incentive to lease the facility to a competitor railroad if the other railroad can handle the traffic more efficiently and can therefore produce higher net revenues from the bottleneck service than the bottleneck owner can by itself. Forced access would merely create another complex layer of regulation that, if carried out in accord with the competitive model, essentially would arrive at the same result. It would make no difference to the competitiveness of the industry.

Forced access would also increase operating costs by making it difficult for a railroad to achieve economies of density. One of the most important characteristics of the railroad industry is that, up to a point, an increase in the volume of traffic over a line or through a yard decreases the per unit cost of the traffic. Higher traffic densities also permit more efficient use of resources, since it requires at least a minimal number of management and operating personnel, equipment, tracks and related facilities to move even a small volume of traffic in a particular area. If two carriers split the traffic, it is likely to require a net increase in the number of crews, locomotive power and freight cars to provide the previous quality and quantity of service.

Forced access would also undermine efficiency in decisions on investment and scheduling needed to accommodate different types of traffic. Not only must a railroad ensure that a particular car moves from its origin to its designated destination, but it must coordinate the movement of several types of traffic with different characteristics. The same segment of a rail line may be used to handle traffic with different time sensitivity, different operating characteristics, and different prices. Fast intermodal trains must be handled differently from high-volume unit coal trains. It is necessary for railroad management to coordinate marketing, operating and investment decisions if it is to achieve anything like an optimal mix of these traffic types along with the most efficient allocation of the required resources. Forced access would make it more difficult to reach and carry out efficient decisions on coordination of these different traffic types.

All of this strongly suggests that the real objective of the proponents of forced access is to achieve reductions in railroad rates through inappropriate regulation of the access charges, not to obtain any real increase in competition. They apparently do not realize or do not care that in the long run this can only lead to deterioration of the rail network and ultimately to loss of service meeting the standards that these shippers themselves require.

The Imposition of Various Forms of "Forced Access" In Other Industries Does Not Support Such Rules In the Railroad Industry

It has been argued that the recent measures imposing access in several other regulated industries demonstrates the feasibility and wisdom of similar measures for railroad freight transportation. But circumstances in those other industries differ markedly from those of the railroads, and those differences mean that the access measures appropriate elsewhere are totally inappropriate for the railroads. There are at least four important and relevant ways in which the electric power, telecommunications and natural gas industries differ from the railroads. First, the economic and regulatory conditions that prompted access regulation in the other industries simply do not exist in the railroad industry. In the three supposedly similar industries, because there is no full end-to-end regulation of rates, failure to impose access threatened to preserve or provide monopoly power to some of its firms and could serve as a significant incentive for self-favoring discriminatory behavior. In railroading, the rules limiting end-to-end charges under the regime of Constrained Market Pricing already provide an effective shield against such problems.

Second, access regulation in the other industries was intended to promote the entry of new competitors and to expand competitive options at a time that new technology and low-cost suppliers were becoming increasingly available. Without access regulation, the owners of the monopoly facilities could discourage or prevent the new entry from occurring. In the railroad industry, forced access to bottleneck facilities does not promise to provide any entry by new rival enterprises.

Third, in the other industries, freedom of access to bottleneck facilities does not impose difficult and costly coordination problems for efficient handling of the activities and outputs of the firms to which access has been granted. In the case of the railroads this is markedly not true, and coordination of trains and cars traversing the same bottleneck but controlled by different firms would clearly be a complex and costly requirement.. Since access promises no competitive benefits to offset these costs, the result would be a net loss in public welfare.

Fourth, access in the railroad industry would seriously jeopardize the ability of railroads ever to achieve revenue adequacy, a risk that also arises, but is not nearly as serious in the other industries.

While this is not the place to discuss why required access was, indeed, highly appropriate in at least some of these other industries, it should be clear that this is no justification for the adoption of similar measures in the rail arena.

The Competitive Model as Guide for Public Interest Regulation

A principle almost universally applauded, but all too often honored only in the breach, is that regulatory rules should serve as a substitute for competition in arenas where competition is difficult to sustain. This means that it is the duty of regulators to require the firms they oversee to behave as they would if their activities were carried out in a competitive marketplace. But this guiding principle also means that regulatory intervention must go no further. It must not force firms to adopt measures that they would not have to accept in a fully competitive market. Experience repeatedly confirms that well intentioned but misguided attempts to constrain pricing, investment and other related activities of firms more severely than they would be by competitive forces introduces inefficiencies that raise costs, degrade service and infrastructure and seriously damage the public welfare.

The rationale for these conclusions is provided by systematic economic analysis as well as by extensive experience. Economics has repeatedly demonstrated that competitive markets lead to economic efficiency, precluding waste, excessive costs and outputs that are not guided by consumer demands. Competitive markets yield prices that reflect the low costs made possible by efficiency and which provide no excessive profits. Moreover, the prices that emerge in such markets can be shown to provide the right incentives for production to be carried out by the most efficient suppliers in the most efficient way currently possible. In short, the competitive market model is an appropriate guide for regulation because there is no known economic arrangement that serves the public's economic interests more efficiently and effectively.

All this, in turn, has several clear implications:

1. Regulators should never intervene where competition is already reasonably effective.
2. All relevant market constraints, including modal, geographic and product competition, must be considered in analyzing the effectiveness of competition for particular railroad prices and services. If railroad pricing and service is effectively constrained by these forces, regulation has no role. It does not matter whether those constraints are provided by railroads with parallel routes or by geographic or intermodal rivalry, as long as the resulting constraints on behavior are sufficiently powerful to prevent monopoly prices and profits and to preclude inefficiency.
3. Since regulation should never force firms to do what they would not accept in a competitive market, rules that threaten to drive their earnings below a competitive level should never be adopted.
4. The obvious consequence of violation of the preceding principle is inadequacy of investment and deterioration of service and infrastructure. No law can force investors to provide resources to an industry that only offers losses to those investors, or whose returns are lower than the returns investors can obtain in other markets.
5. In competitive markets firms often offer access to their facilities to others, including competitors. But they do so only after voluntary negotiation elicits a price that makes it profitable for the owner of the facilities to permit such access.

6. The preceding observations, and particularly the principle that regulated firms should never be forced to do anything they would not do in a competitive market, has several direct implications. First, it indicates that access will be granted voluntarily only if the price is adequate. Firms in competitive markets will not grant voluntary access at inadequate prices. Second, it follows that enforced access, in violation of the competitive market model for regulation, is likely to be a source of inefficiency, inadequate earnings and degradation of service.

7. It will surely be argued that enforced access is immune from these objections because it is a means to introduce competition, rather than a way of evading competitive guidelines. However, if the price of access is set below the competitive level, that is, below the level that would induce access to be provided voluntarily in a competitive market, the result must in effect be subsidized entry. Such entry terms permit inefficient entrants to destroy incumbents, not by virtue of the entrant's superior performance, but through the special financial advantages conferred upon it.

8. In sum, as is recognized by all those who have carefully analyzed the issue, while such subsidized entry has the spurious appearance of enhancing competition, such entry really threatens to undermine both performance and true competition.

This completes our brief review of the logic of the competitive market model for regulation and its implications for the access proposals at issue here. The main conclusion that emerges is that enforcement of access -- except on terms that would lead the incumbent to grant access voluntarily in a competitive market -- is likely to impede or even destroy competition, despite the spurious appearance of such measures as instruments for the promotion of competition.

The Likely Consequences of Imposed Access: Undermined Investment, Increased Coordination Cost and Enhanced Litigation

We can now sum up the implications of our analysis. Legislatively imposed access is currently advocated with the claim that it will enhance competition, increase investment and improve service quality. We have seen that the reality is very different.

Even more to the point, forced access is virtually certain to exacerbate the low-earnings problems of the railroads and thus to handicap them further in their investment efforts. The experience of the decades before the Staggers Act demonstrates clearly and dramatically to what depths railroad investment and quality of service can be driven by such developments. Yet, such a scenario is precisely what is being offered by the proponents of imposed access rules. It is ironic that this undermining of infrastructure is the predictable result of proposals allegedly offered in part to prevent breakdown of service quality. And it is equally ironic that the proposals are offered as a means to attract competition, while they really threaten further reductions in the already inadequate revenues that are a prime disincentive for enhancement of competitive activity.

We have seen that the proposal also threatens to increase costs by contributing to the complexity of coordination of the traffic introduced by imposed access. It also threatens to increase costs by adding new and unnecessary layers of regulation and encouraging litigation.

There is only one credible explanation for the advocacy of imposed access. Its proponents can only be hoping to obtain a legislatively mandated bargain price for the services they get from the railroads whose facilities they want to use. They seek to obtain a price below that which would prevail in an unregulated market. They are hoping that the Board will, in fact, force the railroads to provide them with subsidies. But that makes no sense even in terms of the self-interest of those advocates. Clearly, these proponents of imposed access need the services of the railroads, and they need those services to be provided efficiently and expeditiously. There is no better way to ensure that those needs will *not* be met than to take steps that further handicap the railroads' investment efforts, by driving them still more behind prevailing earning standards in the U.S. economy.

VERIFICATION

I, William J. Baumol, declare under penalty of perjury that the foregoing statement is true and correct. Further, I certify that I am qualified and authorized to file this statement. Executed on June 2, 2000.

William J. Baumol

VERIFIED STATEMENT
OF
WARREN C. WILSON

My name is Warren C. Wilson. I am Senior Manager – Rail Line Planning for Union Pacific Railroad Company ("UP"). I have worked in UP's Shortline Group since 1987, when UP completed its first shortline transaction in the post-Staggers era. For the preceding 20 years, I held various marketing and operating department positions with the Missouri Pacific and Pennsylvania Railroads.

I am responsible for UP's relationships with shortline and regional railroads. In that connection, I am familiar with the contractual relationships between UP and its shortline connections, as well as the process by which many of those shortlines were created to operate lines that were part of the UP system.

This statement addresses the comments made by various parties in Ex Parte No 582 (Sub-No. 1) proposing that the Board adopt rules eliminating – or requiring Class I carriers affirmatively to justify the continued existence of – so-called "paper barriers." The term "paper barriers" is a misleading one used by some to describe a wide variety of contractual provisions between shortlines (and sometimes Class II railroads) and the Class I carriers out of whose systems they were formed that address the interchange of traffic between the shortline and other carriers.

The Board should not adopt rules that would modify or extinguish these contractual provisions. They represent a fundamental part of the transactions freely entered into by the shortlines to acquire their line (by purchase or lease) from the Class I railroad. Altering this aspect of the deal reached voluntarily between these carriers would amount, in essence, to a re-pricing by the Board of the original transaction, either to increase the cash purchase price or rental paid by the shortline, to the shortline's disadvantage, or to deprive the Class I of the value of its asset as reflected in the purchase price (or rental terms) negotiated at arm's length with a willing buyer or lessee.

UP's Shortline Relationships

I begin by explaining what "paper barriers" really are and why they are beneficial to the Class I railroads, shortline railroads, and the shipping community.

Many of the comments in this proceeding create the impression that "paper barriers" are pervasive and onerous restrictions on the interchange options of shortlines that lack any valid justification. Those comments imply that shortlines purchased rail lines for their full going concern value, but nevertheless must abide by interchange restrictions imposed by the selling carrier or pay significant penalties. In fact, most of the UP lines subject to contractual interchange provisions are merely leased, and they remain UP's property. In a few instances, UP sold rail lines for substantially less than their market value based on UP's expectation that it would continue to receive revenues from the traffic generated by the line. Some commenters acknowledge that the contractual limitations on interchange were fair when shortlines were formed, but suggest that the justifications may have disappeared with the passage of time. In fact, contractual provisions addressing interchange serve important ongoing purposes and provide important benefits to the shortline, its Class I connection and the shippers that they serve.

I am familiar with all of the 164 shortlines that connect with UP's system. The vast majority of those shortlines – 88% – are not subject to *any* contractual provisions affecting their ability to interchange with carriers other than UP. Of the remaining lines, many are UP shortline spin-offs which operate on trackage which is still owned by UP and leased to the shortline. UP's lease agreements with these shortlines do *not* prohibit the shortline's interchange of traffic with other carriers. To the contrary, under UP's shortline leases, the shortline is free to interchange traffic with carriers other than UP. Lease provisions addressing interchange with other carriers provide attractive financial terms designed to encourage the shortline to interchange with UP so that UP can share in the revenue generated by the line's traffic. But these incentives *benefit* the shortline, which can choose to reduce or eliminate its rental obligations to UP by interchanging a higher percentage of traffic with UP. In effect, the shortline can choose to pay rent to UP in the form of interchange traffic or in cash. In the 13 years since UP started spinning off branch lines, no leased line has *ever* paid cash. As one shortline operator put it to me, if he has 10,000 carloads annually, he can deliver all of them to UP and pay no rent, or split the traffic between UP and other carriers and pay UP rent.

In a very small number of other cases, UP or its predecessors spun off lines to shortlines or Class II railroads through outright sales. In some of those situations the shortline and UP entered agreements addressing the shortline's interchange of traffic with other carriers, usually in return for a reduced sale price to the shortline.

The rent provisions in UP's shortline lease arrangements that allow payment in traffic rather than cash – and analogous provisions in sale agreements – provide significant ongoing benefits to shortlines. When UP "spins off" a line to form a shortline – whether by sale or by lease – it is providing an asset (i.e., ownership and/or use of the railroad's branch lines) that has going concern value to UP. The aim of these shortline transactions – from the perspective of both UP carrier and the shortline – is to make the line more profitable under shortline operation, as a result of the shortline's better cost structure, more intense focus on on-line shippers and high service levels. But no railroad would voluntarily relinquish such an asset unless the purchaser (or lessee) was willing to compensate the owner for the asset's full value.

By agreeing to accept less cash up-front in exchange for interchange traffic, UP makes it easier for the shortline to acquire use of the line. In the case of a lease, the shortline does not need to pay an up-front purchase price at all. It thereby avoids the need to finance that purchase, which might discourage the acquisition altogether or at least require debt service payments that would have to be recouped in the rates the shortline charges its shippers. Those costs would make the shortline less competitive with other transportation modes and reduce its growth opportunities. This method of financing also allows the shortline to spend more of its resources on upgrading the line to improve service and attract new traffic. Once the line has been leased and the shortline is operating it, this arrangement also lets the shortline reduce or eliminate its rental costs by interchanging with UP, thereby allowing it to charge lower rates (or lower divisions) and invest in improved service. UP's approach to compensation for shortline spin-offs also insulates the shortline from the risk that traffic on the line will not meet expectations, since the shortline can meet its rental obligation by providing a *percentage* of whatever traffic it generates, rather than making a fixed rental payment every month or every year. In the case of a sale, similar benefits are realized when the shortline pays a sharply reduced up-front purchase price.

Contrary to the negative view of those who perceive "paper barriers" as restrictions, contractual benefits to the shortline do not disappear soon after the shortline acquires or leases its line, but continue throughout the period of its operation of the line (and provide a crucial part of the value and consideration to which UP is entitled). Without these arrangements, many of these transactions could never have been closed. UP certainly would not have been willing to lease its lines for nothing if the shortline was to be free to interchange its traffic with all connections and cut UP out of any share of the revenue generated by its leased asset. From the shortline's perspective, leases or acquisitions often would not have been viable if the shortline had been required to service debt or make significant rental payments out of the revenue realized from on-line traffic. The burden of cash rental payments or debt service that reflect the full going concern value of leased lines would drive up shortline costs to the point where their rates or division requirements would render their shippers non-competitive and require the return of the lines to UP or lead to the abandonment of the property.

In light of these substantial benefits associated with the contractual arrangements between UP and its connecting shortlines, it should not be surprising that, of the many comments seeking rules addressing "paper barriers" that were submitted in this proceeding, none were submitted by UP's lessee shortline connections. The shortlines with whom I have discussed these issues much prefer having the option of paying UP in traffic rather than cash.

No Rule Is Required

Even if there were contractual provisions in certain agreements between Class I railroads and shortlines that limited the shortline's ability to make efficient interchange with other carriers, a sweeping new rule would not be an appropriate means of addressing those situations. Such situations are best addressed on a case-by-case basis through negotiations between the individual carriers involved.

UP has cooperated with its shortline and Class II connections in making reasonable accommodations to permit wider interchange with other carriers. For example, one Class II railroad – Dakota, Minnesota & Eastern ("DM&E") – has complained about "barriers" in its contracts with the UP predecessor (CNW) from which DM&E purchased its line. In

CNW's original agreement with DM&E, CNW granted DM&E trackage rights over a segment of CNW track through Owatonna, Minnesota. These rights did not generally permit interchange with other carriers via the CNW track at that location. But UP has nevertheless offered to allow DM&E, for a modest payment reflecting a portion of the construction cost savings DM&E would realize, to construct a new interchange track at Owatonna within the trackage rights limits to handle DM&E's planned Powder River Basin coal traffic with IMRL. UP also allowed DM&E to interchange grain traffic with Iowa Northern via Mason City, Iowa, which was not permitted in the original CNW agreement.

The AAR-ASLRRA Railroad Industry Agreement ("RIA"), signed in 1998, provides a further mechanism for addressing "paper barriers." Under the RIA, all Class I railroads agreed to a process for the renegotiation of any shortline (or Class II) sale or lease agreement that included contractual limits on interchange in exchange for the shortline's agreement to compensate the larger railroad for the value of the lost traffic. The Class I railroads also agreed to permit shortlines to interchange new traffic with other carriers, provided that the "parent" carrier was given an opportunity to handle the traffic.

Despite their RIA rights, no leased shortline has approached UP to renegotiate its agreement under the RIA to secure greater interchange "freedom" in exchange for additional compensation to UP. While certain organizations, like the ASLRRA, argued during the RIA negotiations that all contractual limits on interchange should be eliminated, the fact remains that shortlines enter into agreements containing such limits not because they are coerced, but because the traffic commitments reflected in such provisions offer an innovative, way of reducing their costs of acquiring and operating the Class I's line.

Finally, I want to emphasize that the UP-shortline relationship is not a one-way street. Shortlines have called on UP many times for assistance with economic or physical difficulties. Also, as UP's service has continued to improve and exceed pre-UP/SP merger service levels, we have extended our service offerings in cooperation with shortlines. One example is our new "Express Lane" California-New York perishables service, for which shortlines provide significant traffic. In advance of the train's start-up, UP coordinated the train's service requirements with shortlines to assure that shippers served by the shortlines would benefit. This was a team effort between UP and at least five shortlines to create new traffic, benefiting all the railroads involved. While some may desire to focus their attention on securing new regulations that re-distribute existing traffic, which would add cost to the rail system, it is new manifest traffic obtained through low cost and improved service that will make the industry successful. This was the spirit in which the RIA was signed less than two years ago.

UP strongly believes that UP's leased property cannot be taken from us and used by third parties without regard to the economic terms mutually agreed to at the time of the lease. Although parties to this proceeding have not specifically sought to breach or extinguish contractual obligations between UP and its leased shortlines, the general comments about extinguishing "paper barriers" have caused us to reflect on our future course were the Board to enact a rule purporting to alter the terms of those agreements. If confronted with the choice of accepting less compensation as a result of a breach or elimination of the contractual provisions governing rental obligations, UP in most cases would have no choice but to terminate the contracts and resume operations of its leased lines. Class I operations have become much more efficient since the modern shortline movement first started, and the benefits of shortline operation of UP-owned branches are not as great as they once were. Indeed, in some cases UP believes that it could operate its former-branches at lower cost than the shortline operators. While UP has every intention of honoring its lease agreements and continuing to develop business in cooperation with its connecting "spinoff" shortlines, we would (in all likelihood) be in a position to, and would, choose a different course if we were faced with the requirement of accepting less compensation from – or paying higher divisions to – the incumbent shortline operators.

Verification

I, Warren C. Wilson, declare and certify under penalty of perjury that the foregoing statement is true and correct to the best of my knowledge and belief. I further declare and certify that I am authorized to file this statement.

6/2/2000
Date

Warren C. Wilson